China Economic Monitor

Issue: 2022 Q3

August 2022
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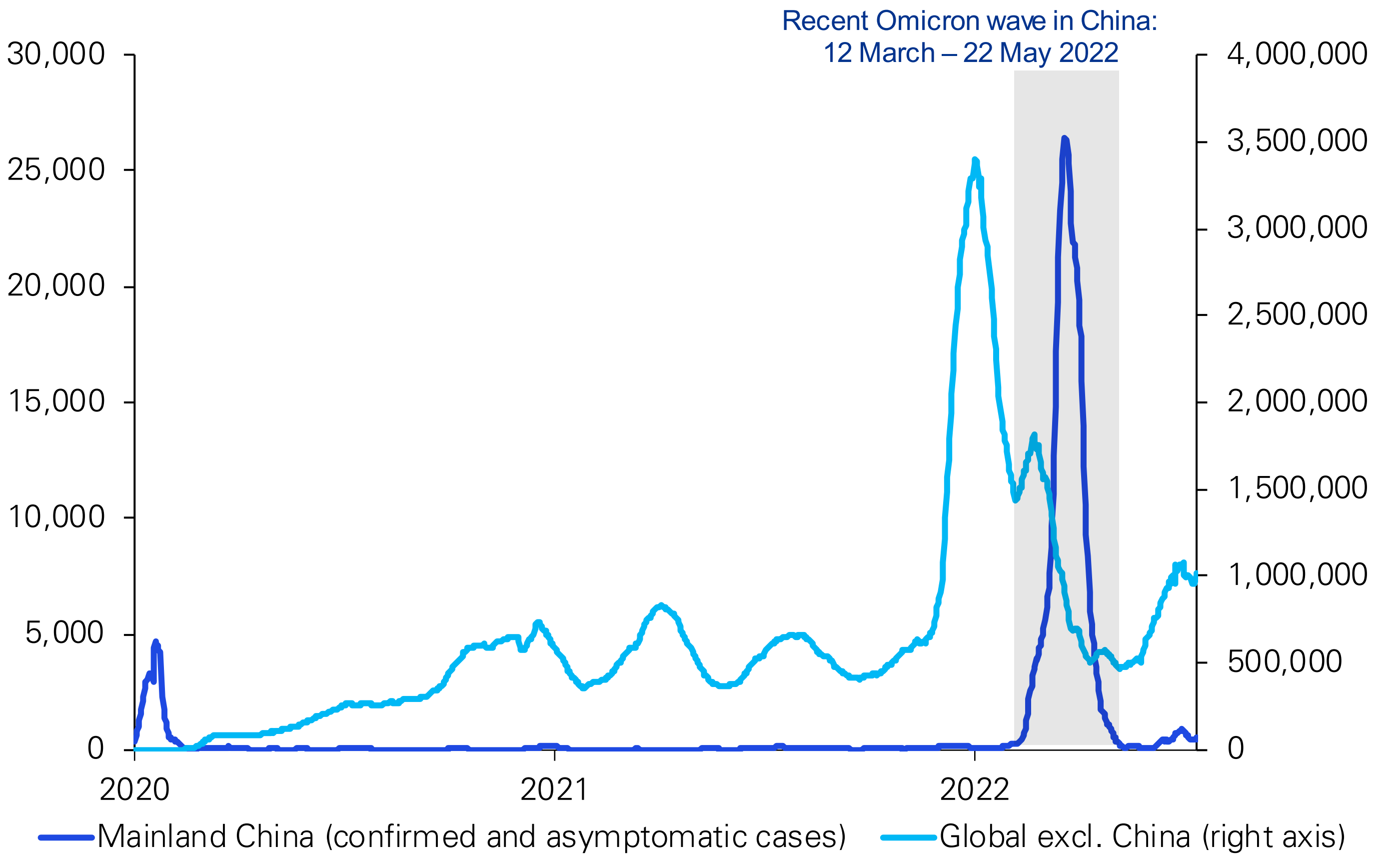
Key takeaways

- China’s GDP grew 0.4% year-over-year (yoy) in Q2. It was the second lowest pace since the quarterly data started in 1992, and was only higher than 2020 Q1 when the COVID-19 pandemic started (-6.9%). On a quarter-to-quarter basis, the economy contracted by 2.6%, reflecting the significant impact of the recent outbreak on the economy.
- To stimulate growth, China’s State Council released a set of 33 supportive measures at the end of May, such as implementing additional tax cuts, accelerating the issuance of local government special bonds (LGSBs) and infrastructure investment, increasing inclusive loans to SMEs, expediting production resumption, and reducing the purchase tax for some autos.
- With the recent outbreak gradually under control and the introduction of additional policy support, economic activity showed broad-based improvement in June from the April trough. Industrial production improved from 0.7% in May to 3.9% in June. However, manufacturing PMI fell into the contractionary zone again in July, suggesting the recovery is still fragile.
- Domestic consumption remained anaemic with retail sales falling 4.6% in Q2 — the largest decline since early 2020. The weak consumption is caused by both movement restrictions due to the pandemic and low consumer confidence. The overall labour market improved in June but the unemployment rate for the 16–24 age subgroup rose to 19.3% — the highest level in the data’s history. With a record 10 million students expected to graduate this year, the stability of the labour market will remain a top priority for the government.
- Export growth beat expectation and remains a key driver to economic growth. Growth of infrastructure investment is accelerating but manufacturing investment has started to retreat from a high level.
- The housing market faces continued pressure with falling property starts and sales. Many local governments have relaxed regional real estate policies to support the market. In addition, China’s central bank slashed the five-year loan prime rate (LPR), the benchmark rate for mortgage loans, by 15 bps in May. It has been reported that homebuyers of some pre-sold housing projects are threatening to stop mortgage payments due to stalled construction by developers. Even though the overall risk to the financial system is still manageable, but certain areas or banks may have higher exposures and the situation should be monitored.
- In the closely-watched July Politburo meeting, the full-year economic growth target (5.5%) set at the Two Sessions in March was not explicitly rejected, but was not mentioned. The current goal is to ‘keep stable employment and inflation, ensure economic growth within a reasonable range, and strive for the best result’. Meanwhile, the meeting also encouraged large economic provinces should take the lead in supporting growth and those places with good conditions should still try to achieve the full year target. We expect China’s GDP to grow 5.5% in the second half of the year and 4.1% for the full year of 2022.

The Omicron variant caused high levels of new inflections in China during March–May, but has since eased

COVID-19 daily cases in mainland China

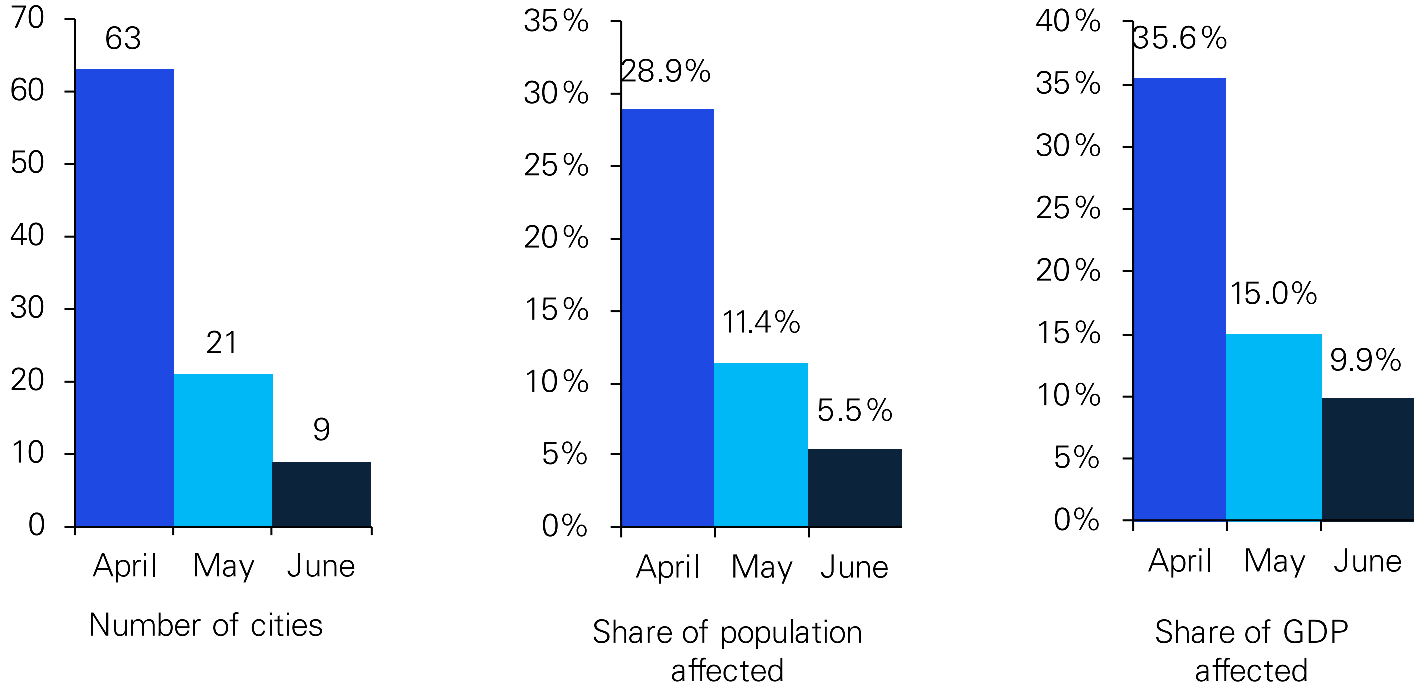


Source: Wind, KPMG analysis. Data through August 7 2022.

- With the Omicron variant starting to spread around the world since last November, global daily new infections broke previous highs and reached over 3.3 million in January 2022. Global infections have retreated in April–May but appear to be picking up again in recent weeks.
- In the three months of March–May, China recorded 774 thousand new cases — seven times more than the total number of cases in the past two years combined. However, the outbreak has been put under control, and daily new infections have dropped below 1,000 since late May.

The recent outbreak had a significant impact on the economy in Q2

Cities containing one or more medium- or high-risk areas in mainland China



- Even though new infections in China are still low compared with the global standard, the Omicron outbreak had a significant impact on the economy. There were 63 cities containing one or more medium- or high-risk areas in April, representing about 28.9% of China's population or 35.6% of GDP.
- As infections have retreated since late May, quarantine measures have been gradually lifted. The number of cities with risk areas dropped to 9 in June, accounting for 5.5% of the population or 9.9% of GDP. As a result, economic activity showed broad-based improvement from the April trough.

Source: Wind, KPMG analysis. Data through June 30 2022.

The pace of China's economic recovery is still uneven

Growth rate of major economic indicators, %

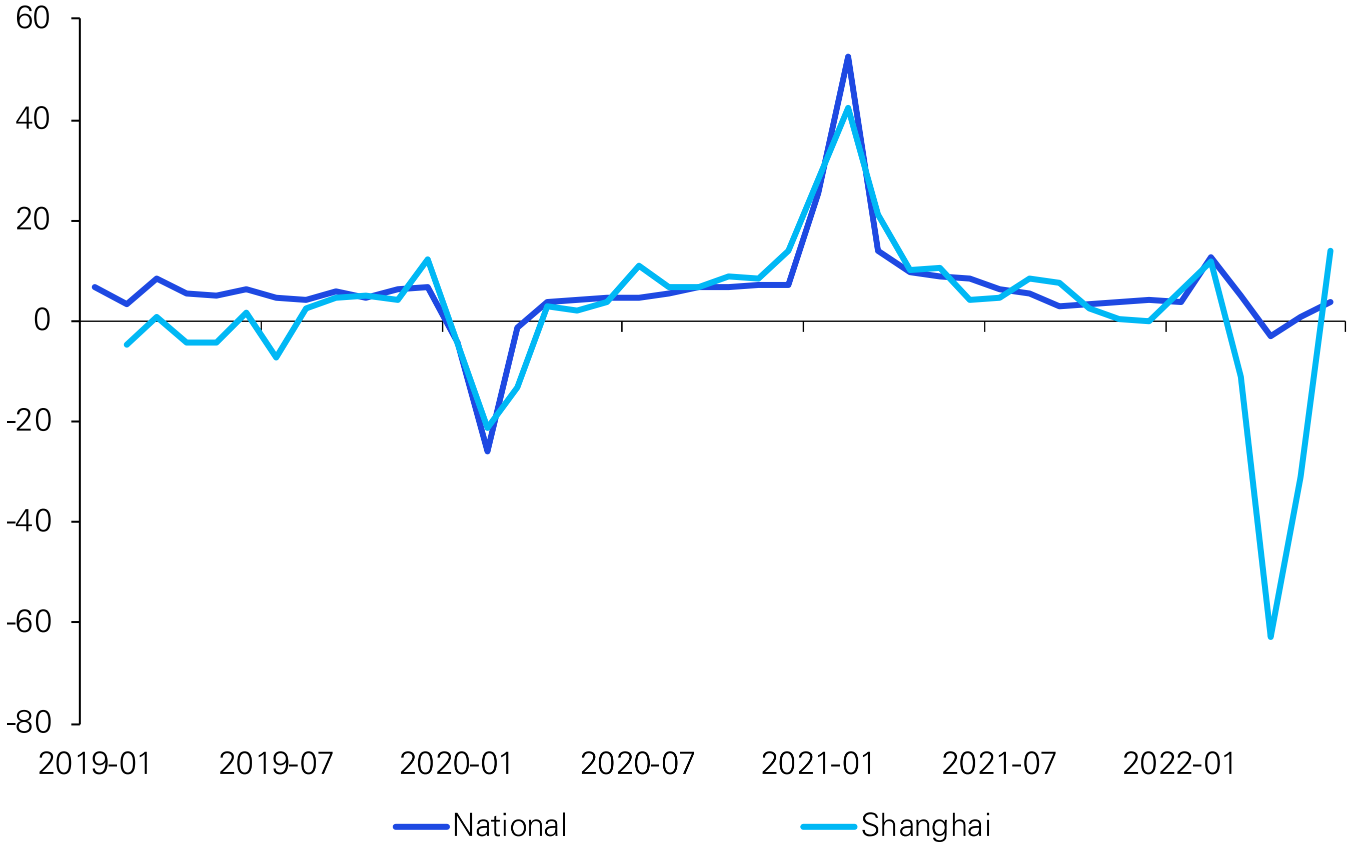
	2017–19 Average	Q1 2020–21 Average	Q2 2020–21 Average	Q3 2020–21 Average	Q4 2020–21 Average	Q1 2022	Q2 2022
GDP	6.6%	4.9%	5.5%	4.8%	5.2%	4.8%	0.4%
Industrial production	6.2%	6.8%	6.6%	5.3%	5.5%	6.5%	0.6%
Retail sales	9.0%	4.1%	4.6%	3.0%	4.1%	3.3%	-4.6%
Fixed asset investment	6.2%	2.7%	5.6%	3.2%	3.7%	9.3%	4.2%
Exports	6.1%	13.4%	14.2%	16.0%	19.7%	15.7%	12.9%
Imports	9.8%	12.0%	14.2%	14.1%	14.4%	10.2%	1.7%
Income per capita	6.5%	4.5%	5.9%	4.9%	5.1%	5.1%	0.4%
Fiscal revenue	5.8%	3.2%	5.2%	4.6%	-1.5%	8.6%	-28.0%
Fiscal expenditure	8.2%	0.1%	-1.5%	2.3%	5.5%	8.3%	3.7%

Source: Wind, KPMG analysis. Note: growth of GDP, industrial production, and income per capita are in real terms, while the rest is in nominal terms.

- China's GDP grew 0.4% yoy in Q2. It was the second lowest growth pace since the quarterly data started in 1992, and was only higher than 2020 Q1 when the COVID-19 pandemic just started (-6.9%).
- Exports remained as the key driver of the recovery. Investments in manufacturing and infrastructure rebounded due to policy supports. In contrast, retail sales contracted 4.6% in Q2 due to the Omicron outbreak.
- Fiscal revenue declined to -28% yoy in Q2 due to large value-added tax refunds. It fell 10.2% in the first half of 2022, below the annual target growth rate of 3.8%.

Industrial activities rebounded from the April trough

Industrial production, yoy, %

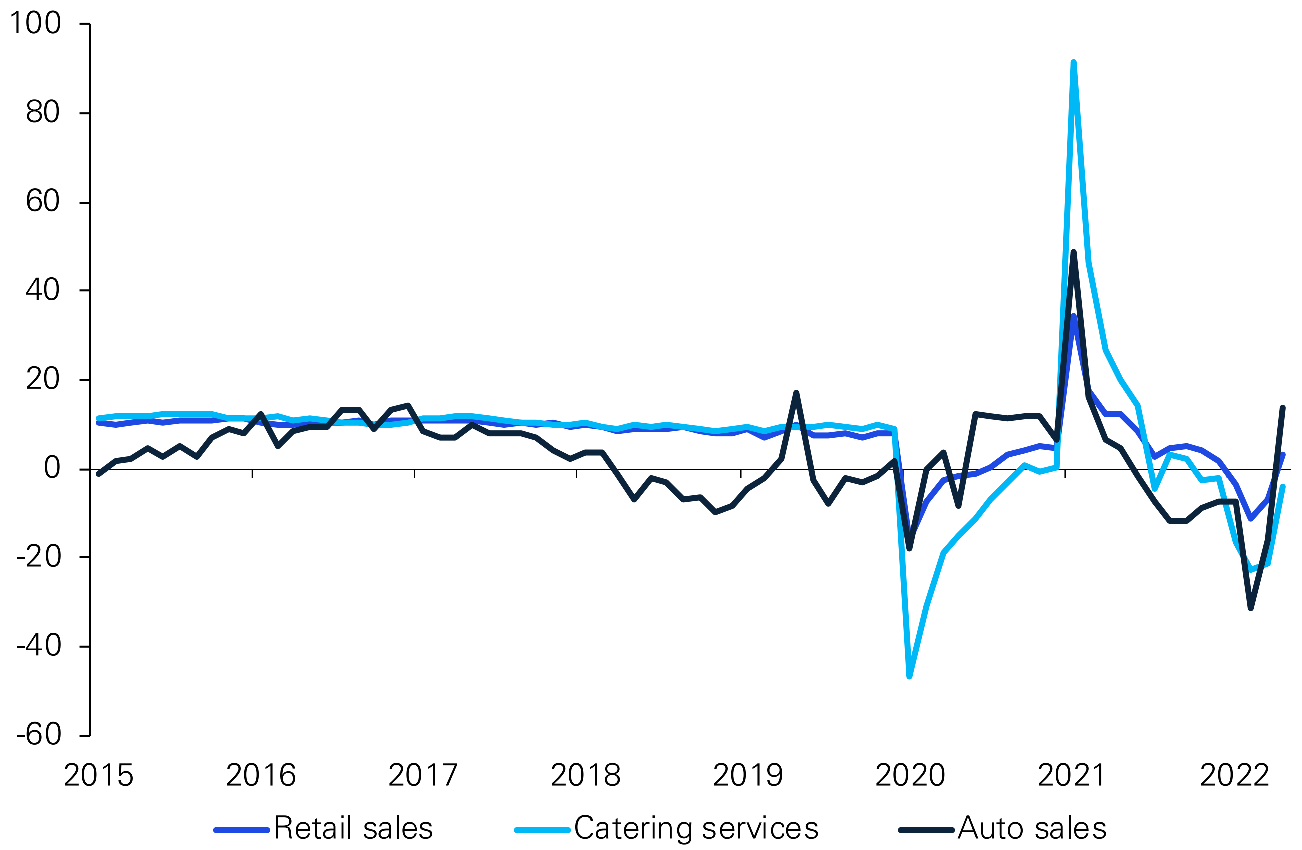


Source: Wind, KPMG analysis.

- Shanghai, one of China's largest economic hubs, represented 3.8% of the national GDP in 2021. The city saw a major impact from the recent outbreak. Amid expansive lockdowns and logistics disruptions, Shanghai's industrial production plunged 63% in April, a record decline for the city and far exceeding the impact seen in early 2020 when the pandemic just started.
- With the pandemic gradually put under control, logistics has improved and industrial activities has rebounded, especially in auto and machinery. National industrial production grew 3.9% in June, up from -2.9% in April. Meanwhile, Shanghai's industrial output surged 13.9% in June.

Consumption is still weak but shows improvement with strong auto sales

Retail sales, yoy, %

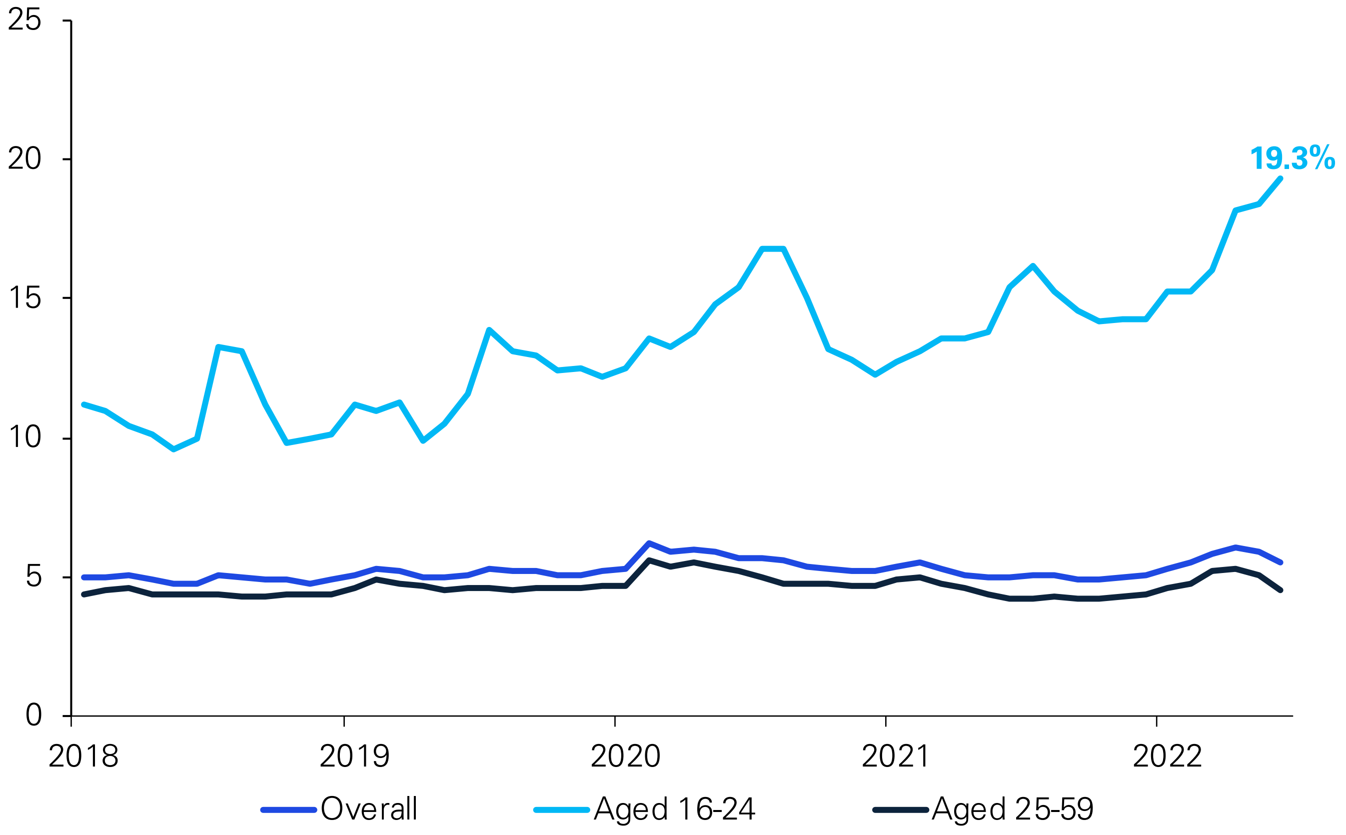


Source: Wind, KPMG analysis.

- Growth of retail sales returned to positive in June after three months of contraction. It grew 3.1%, higher than market expectations.
- Auto accounted for around 10% of total retail sales. Auto sales rebounded in June, up 13.9%, driven by supply chain improvement, policy supports through reduced purchase tax, and lower base for comparison.
- Although hard hit by the virus spread, catering services rebounded in June. The services PMI jumped to 54.7% in June from 47.8% in May, suggesting a recovery in services consumption in H2.

The total unemployment rate has retreated but challenges remain for the younger cohort

Urban surveyed unemployment rate, %

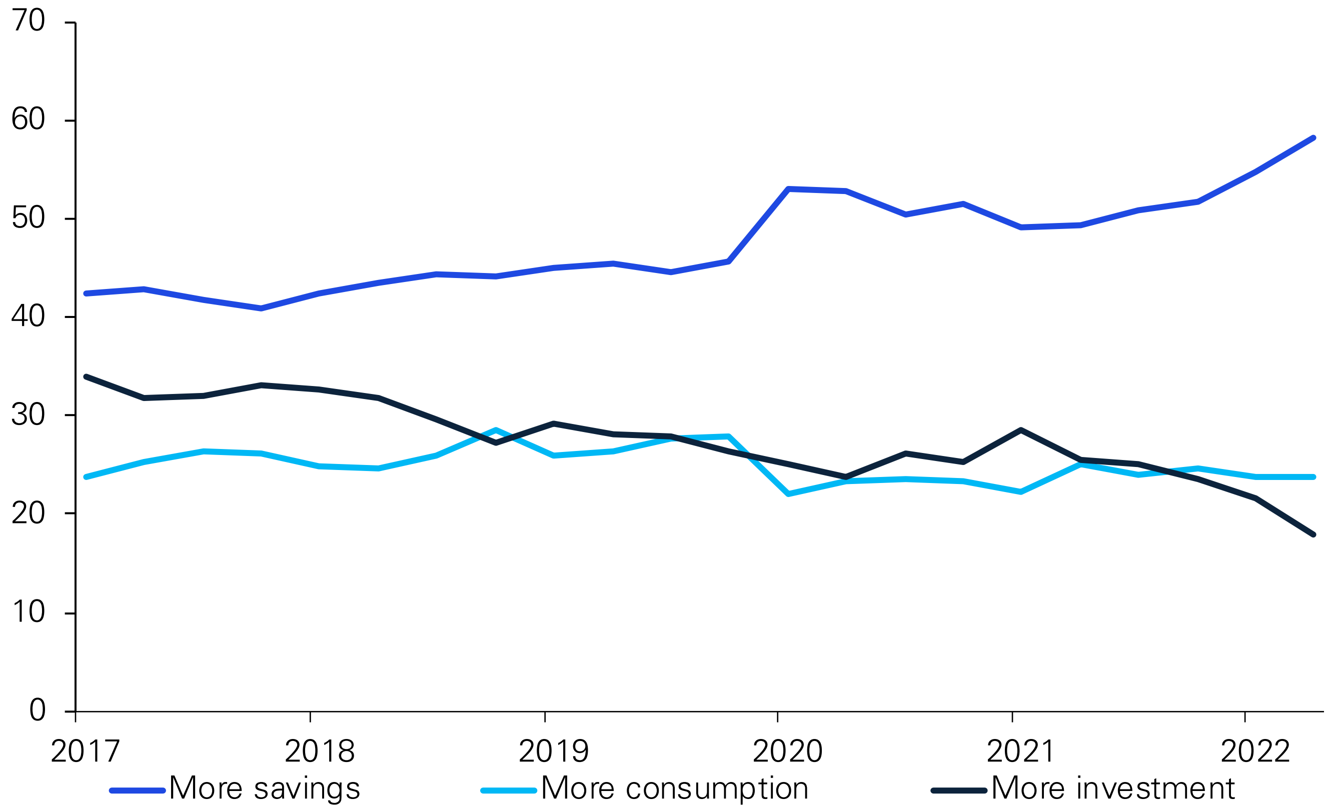


Source: Wind, KPMG analysis

- The urban surveyed unemployment rate declined to 5.5% in June from 6.1% in April. The unemployment rate of people aged 25–59 stood at 4.5% in June, the lowest level so far this year.
- However, the unemployment rate of people aged 16–24 is still high and rose to 19.3% in June, the highest level in the data's history. A record level of 10 million students are expected to graduate this year and hence labour market stability will remain a top priority for the government.

Household sentiment for consumption is still weak

Share of surveyed households who indicate that they will either increase savings, consumption or investment

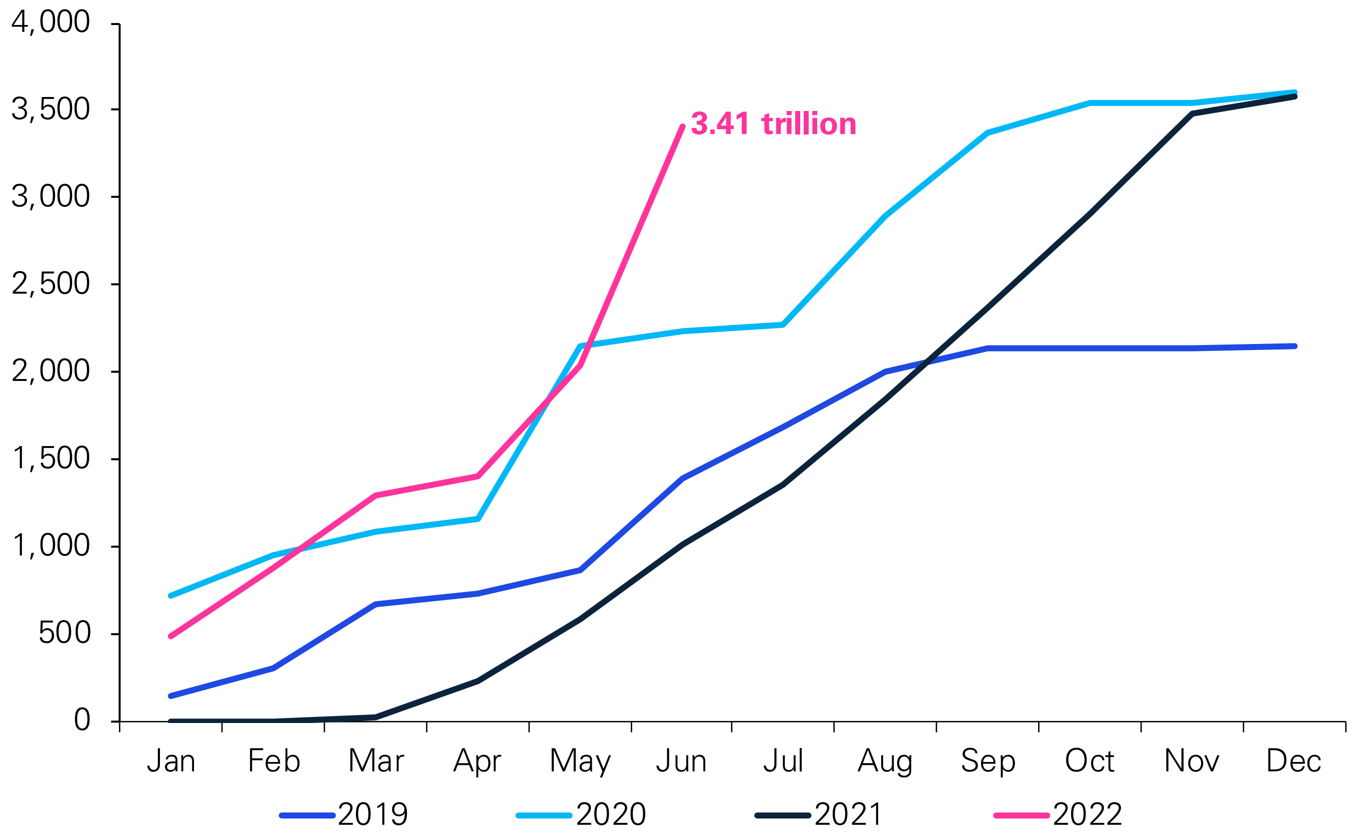


Source: The PBoC, KPMG analysis

- According to a survey by the People's Bank of China (PBoC), household sentiment for income growth deteriorated to 44.5 in Q2, the second lowest in history. As a result, households are still cautious about consumption and investment. The share of surveyed households that are planning to increase investment declined to a record low of 17.9%, while the share of those planning to increase savings reached 58.3%, the highest level on record.
- We expect income sentiment to improve in H2 and support a gradual recovery of consumption.

Local governments have accelerated the issuance of special bonds to support infrastructure investment

Issuance of LGSBs, year to date, RMB billion

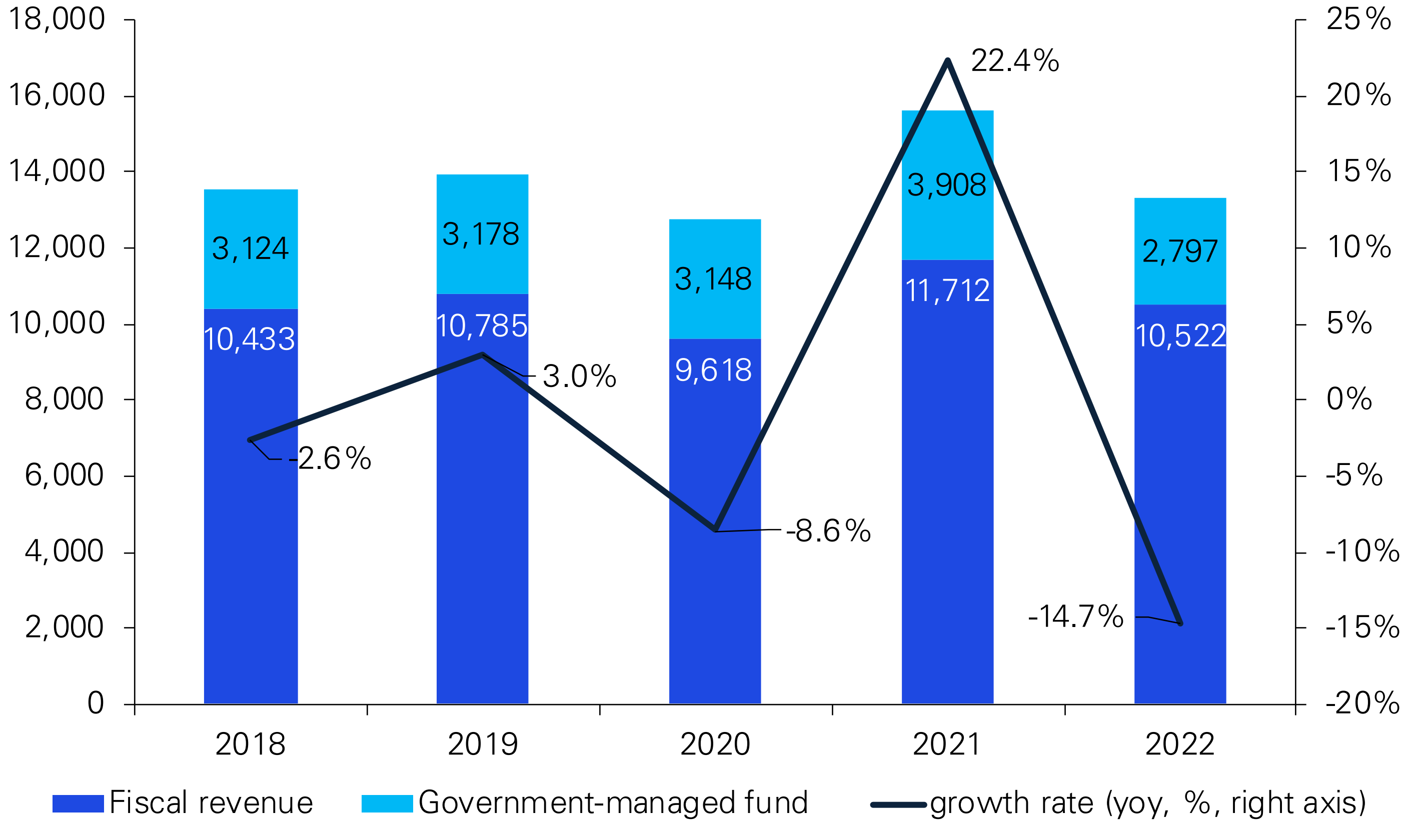


Source: Wind, KPMG analysis

- The government accelerated the issuance of local government special bonds (LGSBs), a major funding source for infrastructure investment. In H1, the government issued a total of RMB 3.41 trillion LGSBs, 93.4% of the annual quota. In June alone, it issued RMB 1.37 trillion LGSBs, the highest level in history. The pace of issuance was much faster than the previous years.
- As about 65% of LGSBs are targeted at infrastructure projects, a faster issuance provides better funding for construction. Infrastructure investment rose by 8.6% in Q2 and 9.3% in H1.
- Infrastructure projects such as water conservancy, transportation and urban renovation have been accelerated. We expect infrastructure investment to remain strong in the second half of this year.

Government revenue dropped due to tax refunds and falling land sales

Government revenue in H1 of each year, RMB billion

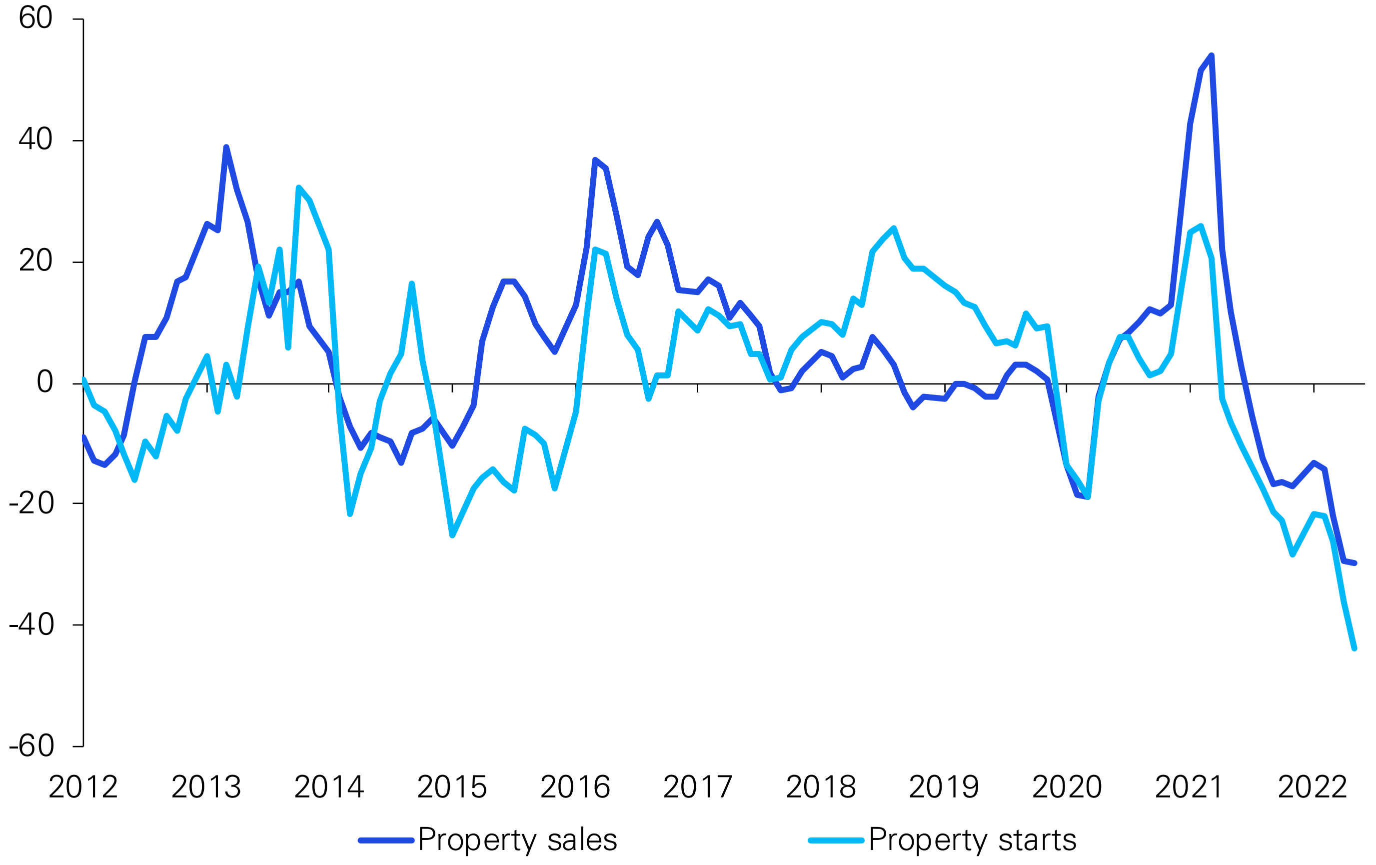


Source: Wind, KPMG analysis

- Due to a large refund of value-added taxes (totalled RMB 2 trillion as of mid-July), fiscal revenue declined 10.2% in the first half of 2022, far below its annual target of 3.8%.
- The government-managed fund declined by 28% in H1, mainly due to the sharp drop in land sales. The land revenue for local governments deteriorated to -31.4% in H1.
- Fiscal revenue and government-managed fund are the two major income sources for the government. The combined revenue dropped 14.7% in the first half of 2022. Weak government revenue may limit the room of additional fiscal supports by local governments.

The housing market faces continued pressure with falling property starts and sales

Growth of property starts and new home sales, yoy, three-month moving average, %

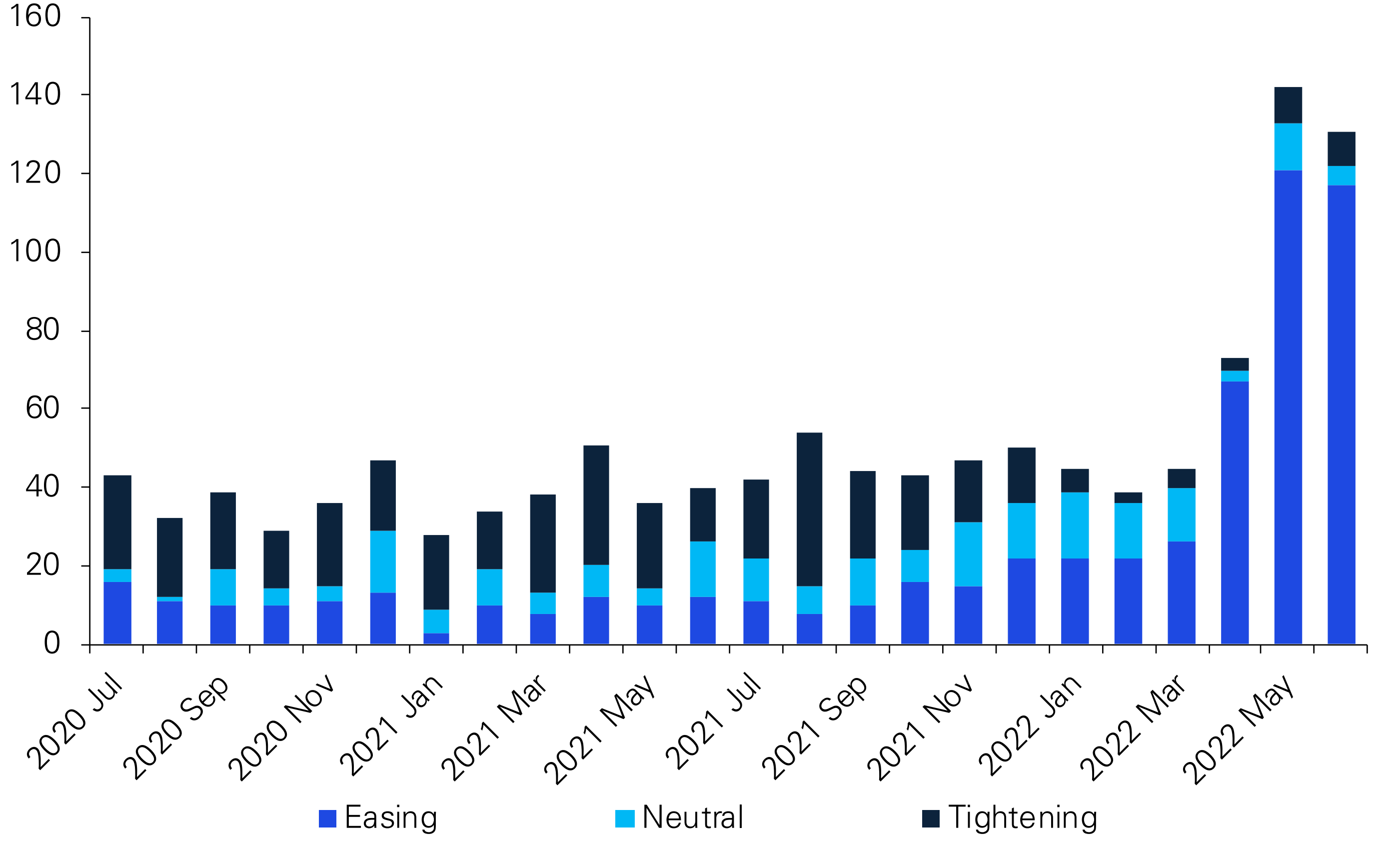


Source: Wind, KPMG analysis

- China's real estate market has been facing significant pressure since the second half of 2021. Housing starts and new home sales have both continued to decline. Real estate investment fell by 5.4% in H1 from a year ago.
- Liquidity pressure has been a key challenge faced by developers, especially for some private-owned enterprises.

Local governments have changed direction and are announcing easing measures to support the property market

Number of new real estate policies released by local governments

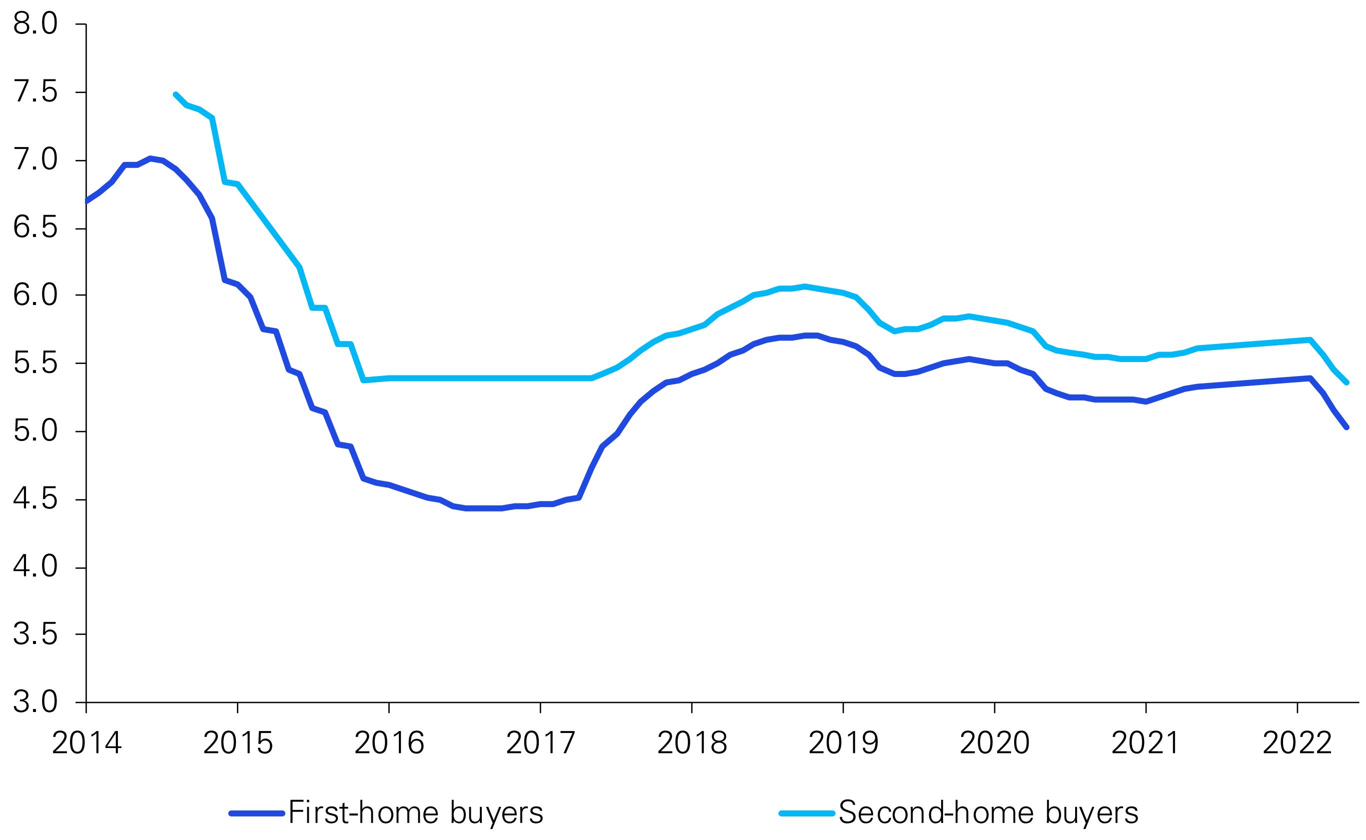


Source: CRIC China, KPMG analysis

- To cushion the slowdown, more local governments are announcing easing policies on the property market, such as relaxing restrictions on property purchases, cutting mortgage rates and lowering down-payment ratios.
- Local governments released 121 easing policies in May and 117 in June, a sharp reversal from the second half of 2021 when most of the policies announced were tightening.

The mortgage rate for homebuyers has been lowered

National average of mortgage rate for homebuyers, %

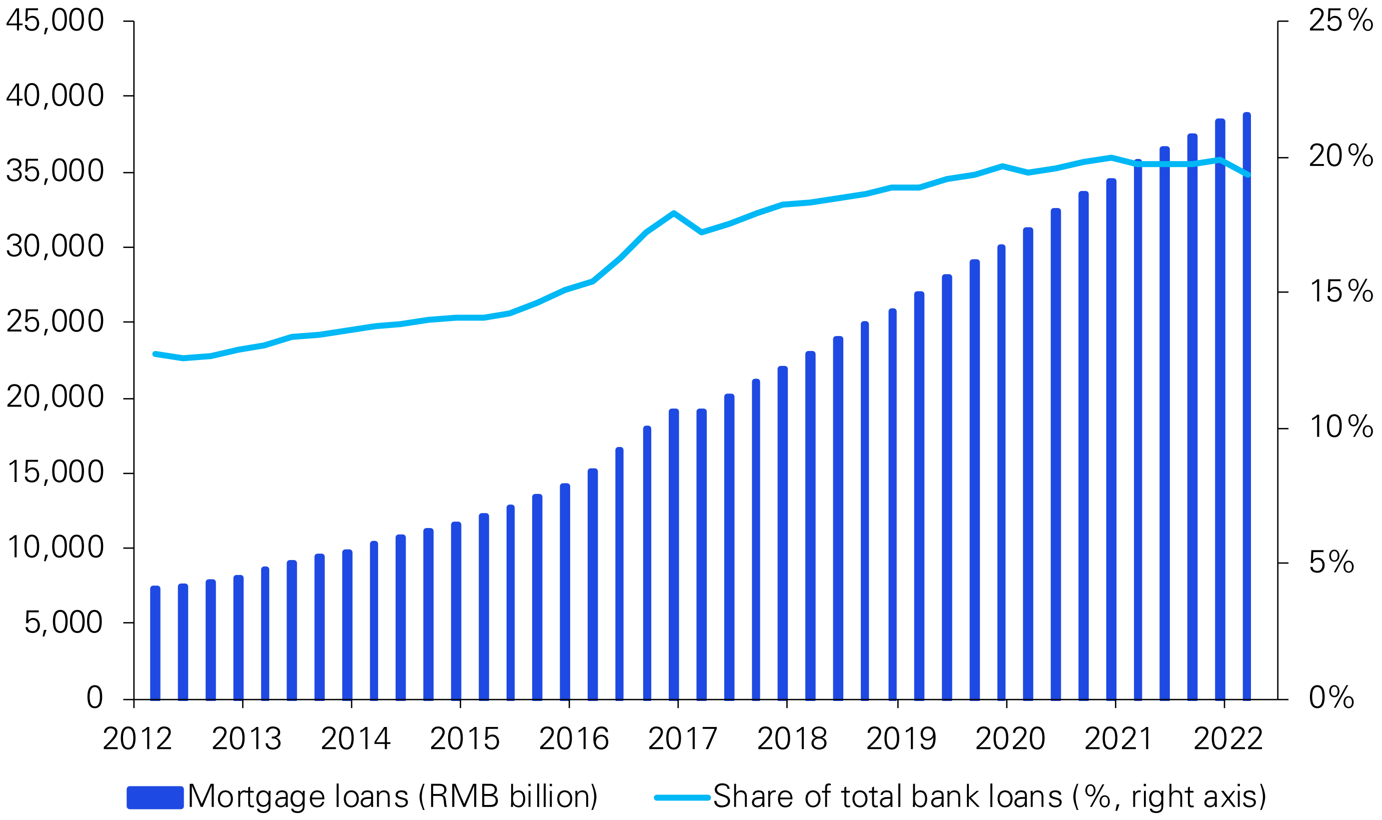


Source: Wind, KPMG analysis

- China's central bank has cut mortgage rates for homebuyers. It slashed the five-year LPR, the benchmark rate for mortgage loans, by 15 bps in May. This was the largest reduction since the new interest rate mechanism came into effect in 2019.
- It also lowered the minimum mortgage rate for first-time homebuyers by 20 bps on 15 May. As a result, the minimum rate for first-home mortgages has been lowered by 35 bps (from 4.60% to 4.25%) in some cities.
- The real estate market contributes to 15–20% of China's economy and is critical for economic growth. The overall regulatory tone of 'housing is for living, not for speculation' will likely remain unchanged, but we expect more easing policies to be adopted to support stability of the market.

Overall risk of recent mortgage boycotts due to stalled construction is still manageable but should be closely watched

Mortgage loan and its share in total bank loans



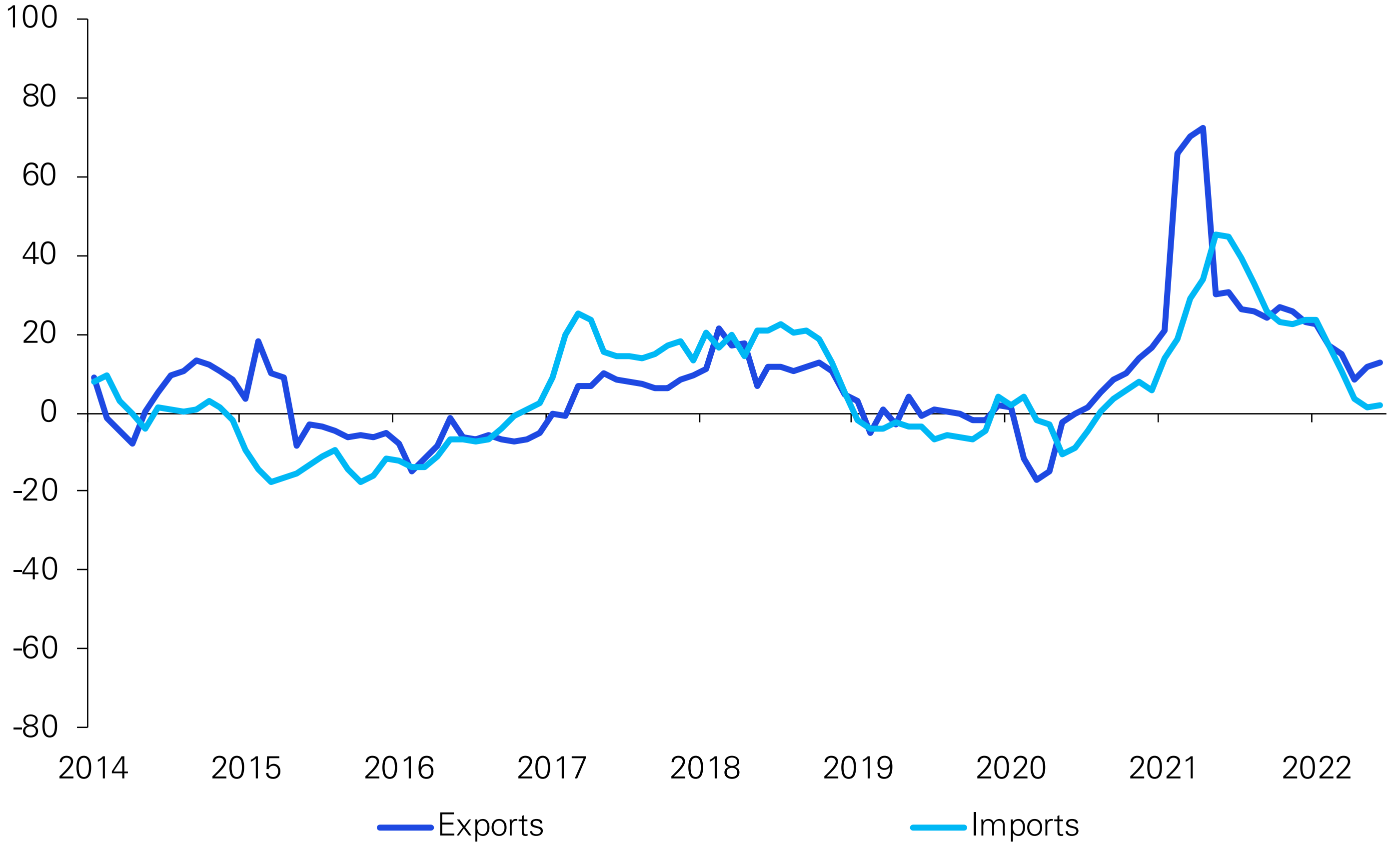
Source: Wind, KPMG analysis

* E-house estimate

- There have been news reports that homebuyers of some pre-sold housing projects are threatening to stop mortgage payments if developers do not resume construction.
- Current mortgage loans totalled RMB 39 trillion, about 20% of total bank loans. The amount of mortgage loans for which homebuyers may stop payments is estimated at around RMB 1 trillion in mid-July*, about 2.5% of the outstanding mortgage loans or 0.5% of total bank loans.
- Even though the overall risk to the banking system is still manageable, some cities and developers may have a higher exposure and the contagious risk should be monitored. The government is taking actions to address the issue. For example, China Banking and Insurance Regulatory Commission (CBIRC) has asked banks to provide credit to eligible developers so that they can complete construction. Some local governments are setting up relief funds to help developers with liquidity issues.

Exports beat expectation, but a slower global economy and geopolitical uncertainty cloud future growth

Growth of exports and imports, yoy, 3mma, %

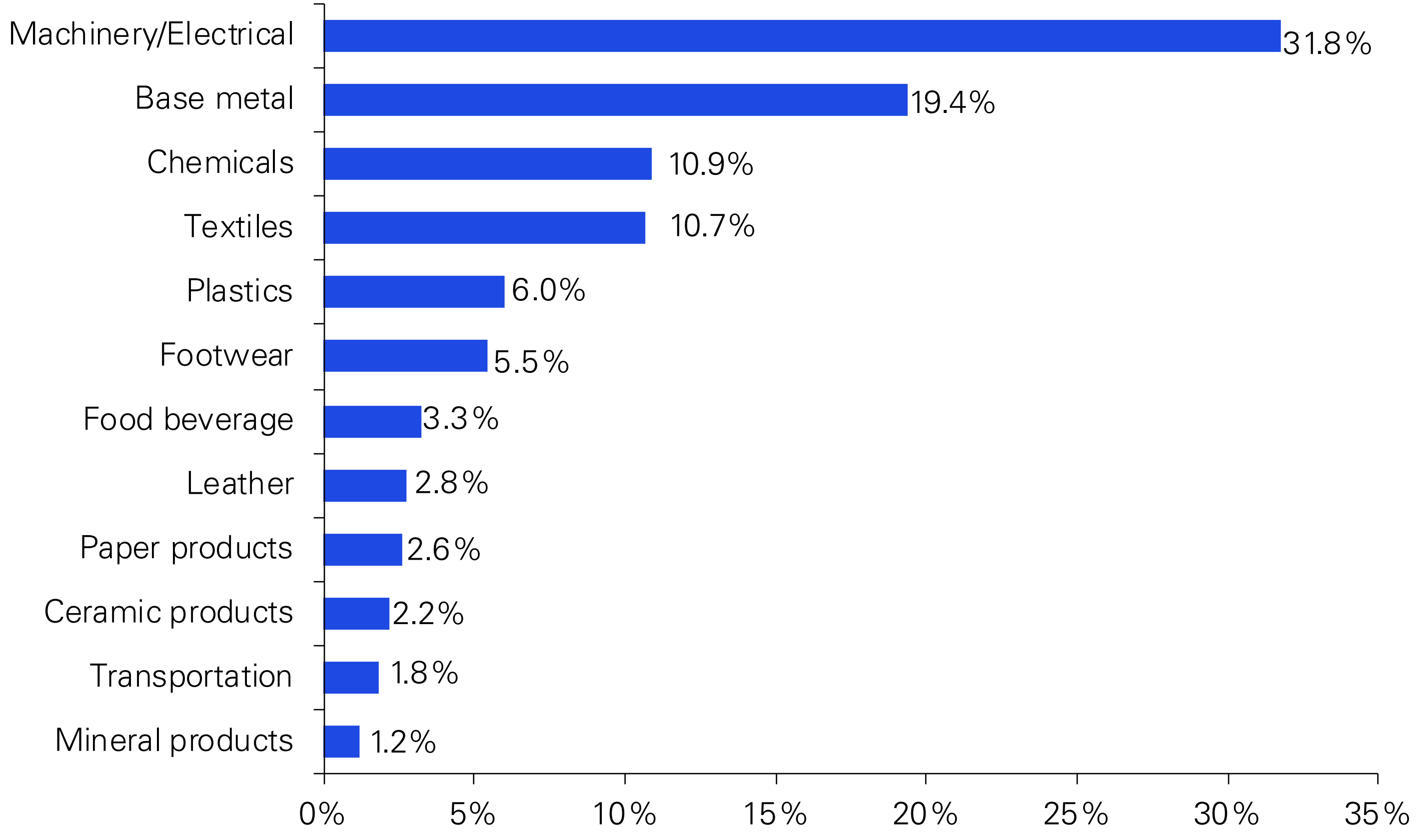


Source: Wind, KPMG analysis

- Driven by continued external demand, exports have remained strong. Export growth rebounded from 3.7% in April to 17.9% in June, beating market expectations.
- In contrast, import growth in June slowed to 1.0% from 4.0% in May, weighed down by logistic disruptions and subdued domestic consumption.

Machinery and electrical products, base metal and chemicals were the main drivers for the robust export growth in Q2

Contribution to China's Q2 export growth by product, %

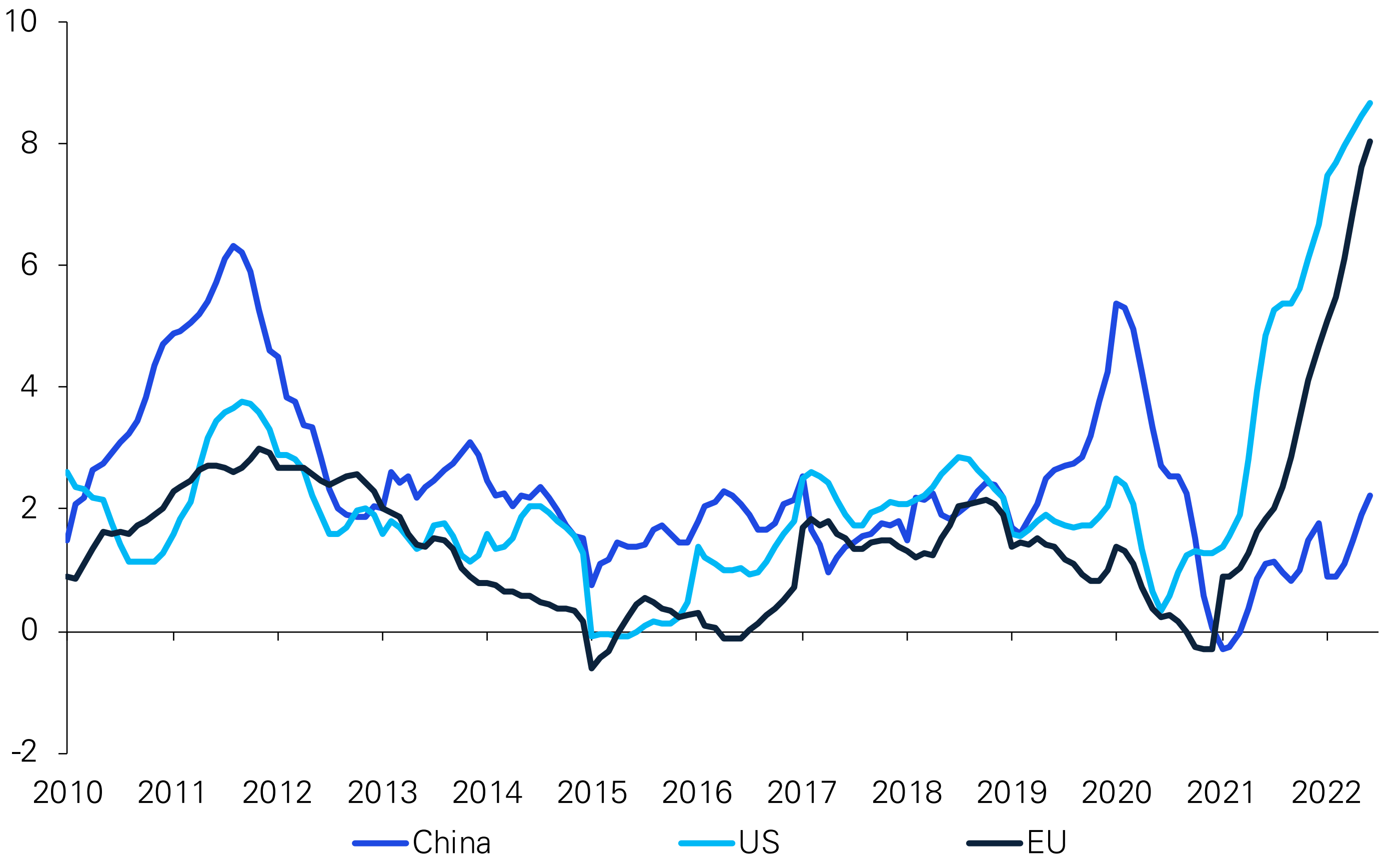


Source: Wind, KPMG analysis

- Q2's robust export growth was mainly driven by machinery and electrical products. Export of new energy products such as solar cells and lithium-ion batteries saw particularly strong increase.
- Exports of base metal, such as steel and copper, and chemicals also grew rapidly, driven by the recovery of overseas production and a surge in commodity prices.
- China's export structure is also seeing further improvement. High-tech exports recorded rapid growth in June, especially in life science technology and chips.

Inflation has remained relatively low in China compared with other markets but may pick up in H2

Consumer price inflation, yoy, three-month moving average, %

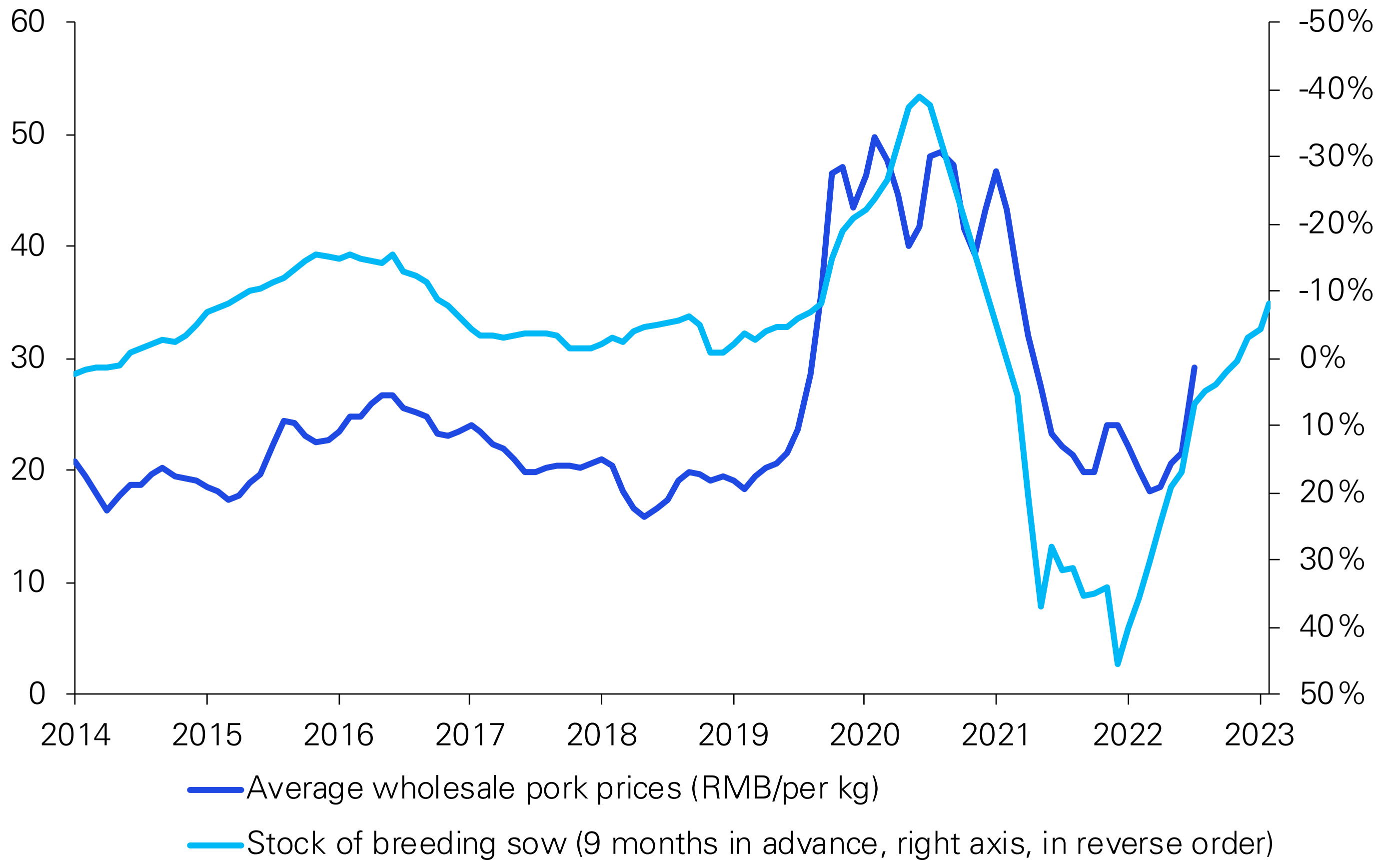


Source: Wind, KPMG analysis

- Inflation has been a top concern to many economies. For example, US consumer price inflation hit record highs of the past four decades. Rising inflation is attributable to many factors such as large stimulus measures introduced during the pandemic, price-wage spirals, supply chain disruptions, and geopolitical tensions.
- In contrast, inflation has remained relatively low in China, giving the Chinese government some room in its monetary policy. China is the only major economy in the world that is still adopting an easing policy stance to support growth.
- China's inflationary pressure is likely to gradually pick up in H2, due to rising food prices and a consumption recovery.

Pork price, an important contributor to the CPI fluctuations, is facing upward pressure

Pork prices and breeding sow stock

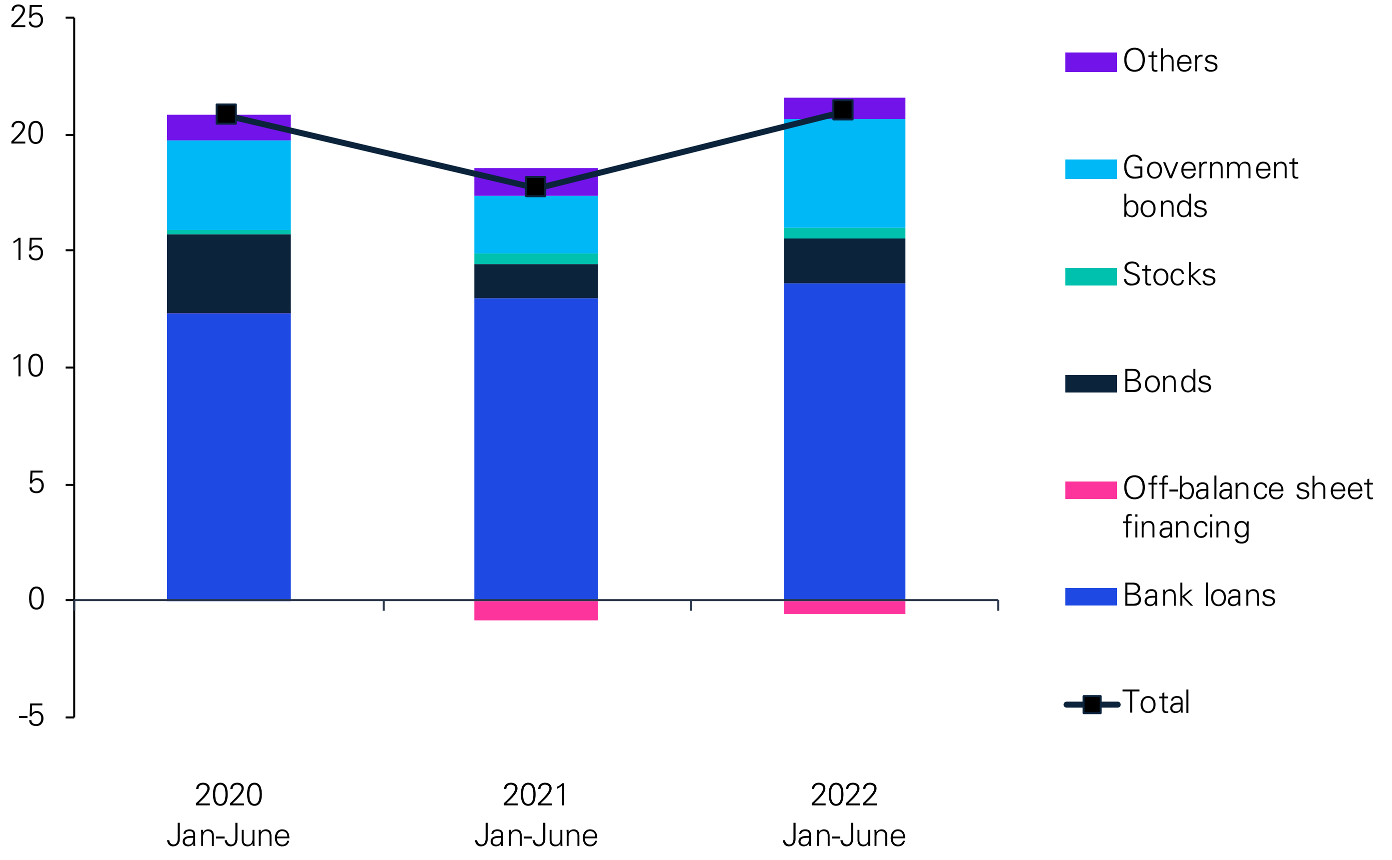


Source: Wind, KPMG analysis

- Food accounts for nearly 30% of China's consumer price calculation, and pork prices are an important contributor to the CPI fluctuations.
- Falling pork prices had been a key reason for the low inflation in China for the past one and half years, but pork prices have been rising recently. The average wholesale pork prices grew 31% in July from a year ago and were up nearly 60% from the March lows.
- The stock of breeding sows tends to be a leading indictor of pork prices. Slower growth of breeding sows may put upward pressure on future pork prices.
- To mitigate the price increase, the government is considering to release state reserves of pork to increase supply.

Bank loans and government bonds are the major sources of growth in total social financing (TSF)

New TSF by sector, RMB trillion

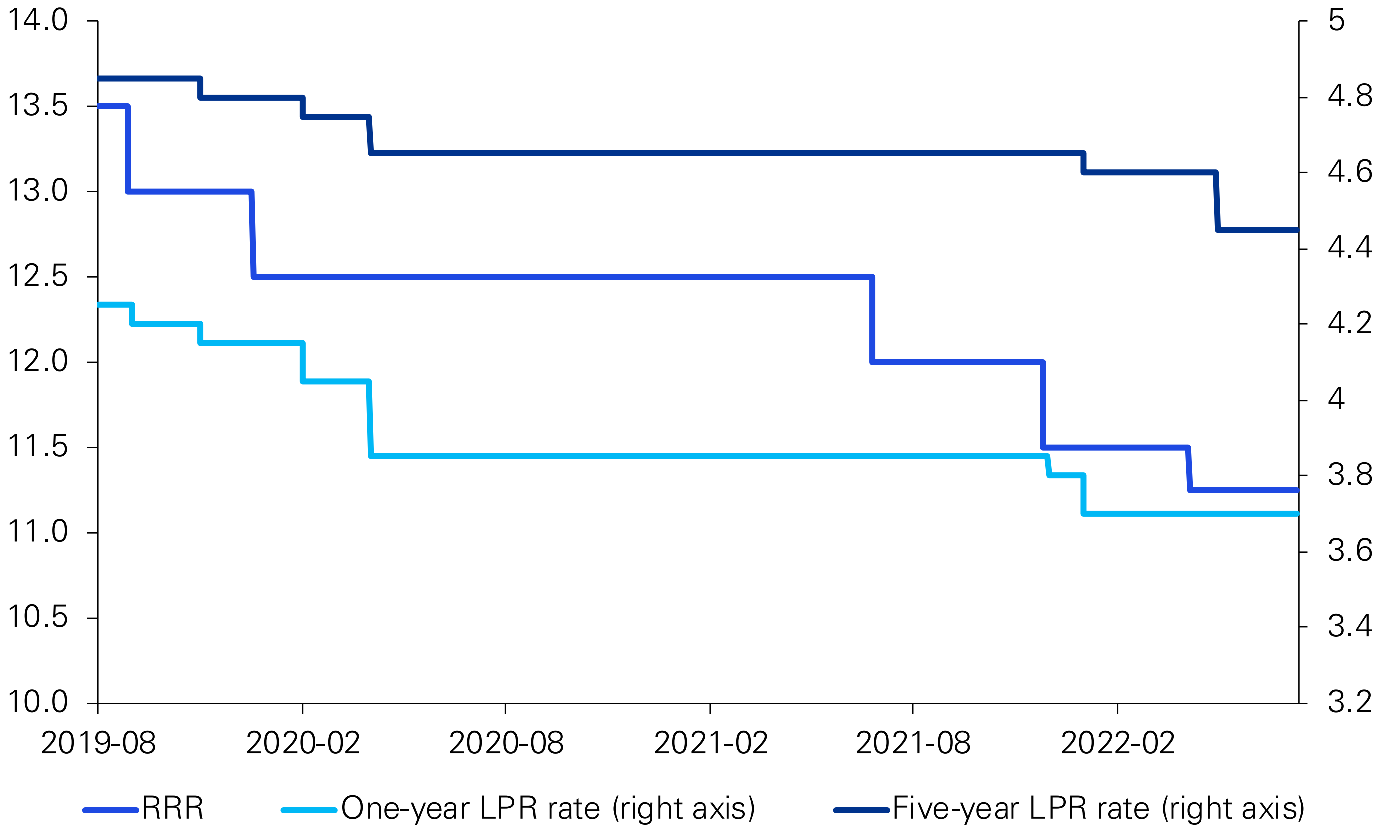


Source: Wind, KPMG analysis

- New TSF, a measure of the total liquidity provided by the financial sector to the real economy, increased by RMB 21.0 trillion in the first half of this year, RMB 3 trillion higher than the same period of last year, and similar to its level in 2020.
- New bank loans increased to RMB 13.6 trillion in January–June, RMB 0.6 trillion higher than H1 2021. The strong bank loan data in June was mainly driven by monetary policy easing. New bank loans are expected to surpass RMB 20 trillion for the full year of 2022.
- As Beijing accelerated bond issuances in H1, government bond issuance rose to RMB 4.6 trillion in January–June, RMB 2.2 trillion higher than the same period in 2021.

China's central bank maintained an accommodative policy stance to support growth

Required reserve ratio (RRR) and loan prime rate (LPR), %

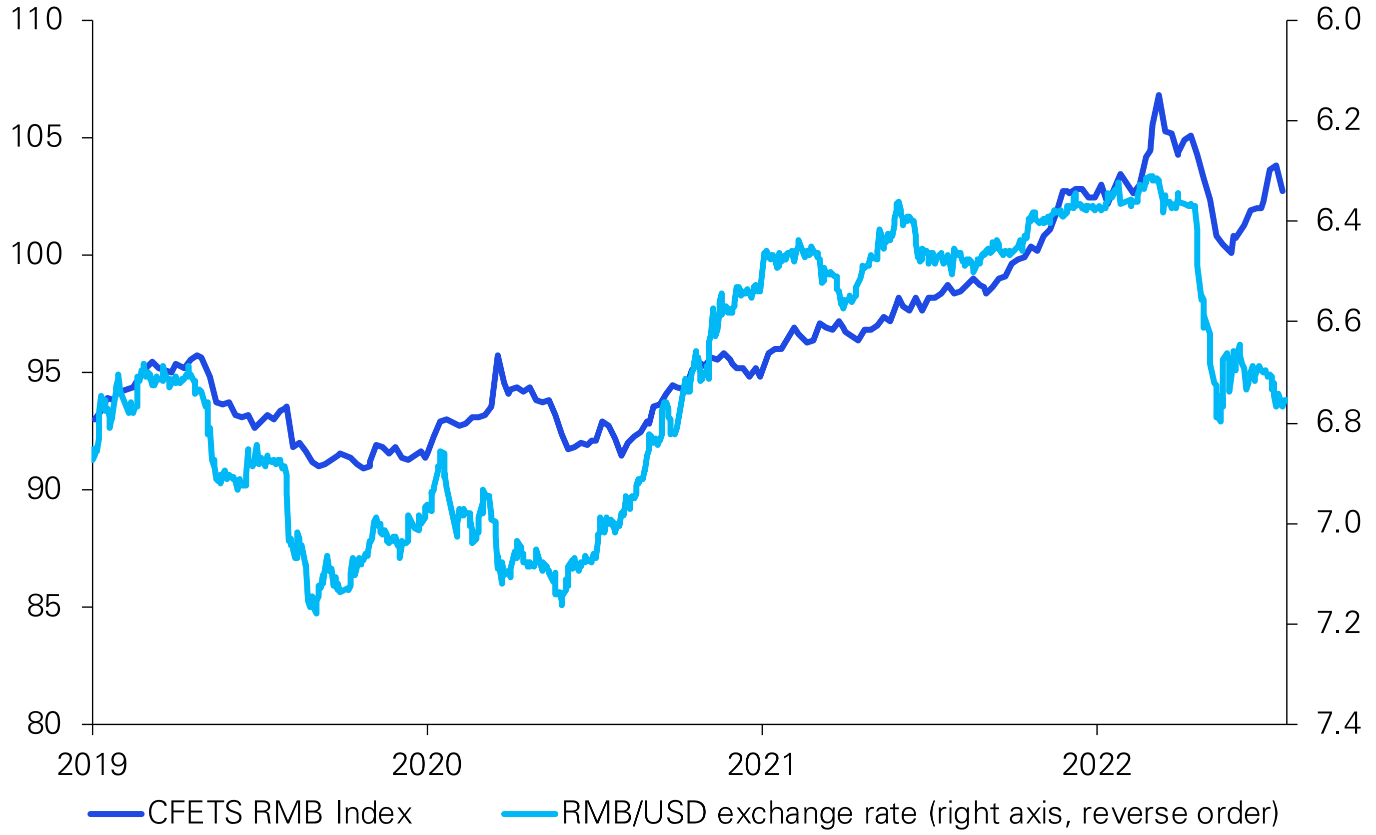


Source: Wind, KPMG analysis.

- Although many central banks around the world are raising interest rates to control soaring inflation, China has adopted an easing stance to support growth.
- Since December 2021, the PBoC has accelerated monetary easing to support economic growth, including two required reserve ratio (RRR) cuts, one medium-term lending facility rate (MLF) and reverse repo rate cut, as well as slashed the one-year LPR and five-year LPR.
- The central bank has also increased its direct credit support to SMEs, green investment, tech and elderly care via channels such as special relending facility.

The RMB exchange rate depreciated against the USD but remained relatively stable against other major currencies

China Foreign Exchange Trade System (CFETS) index and RMB/USD exchange rate

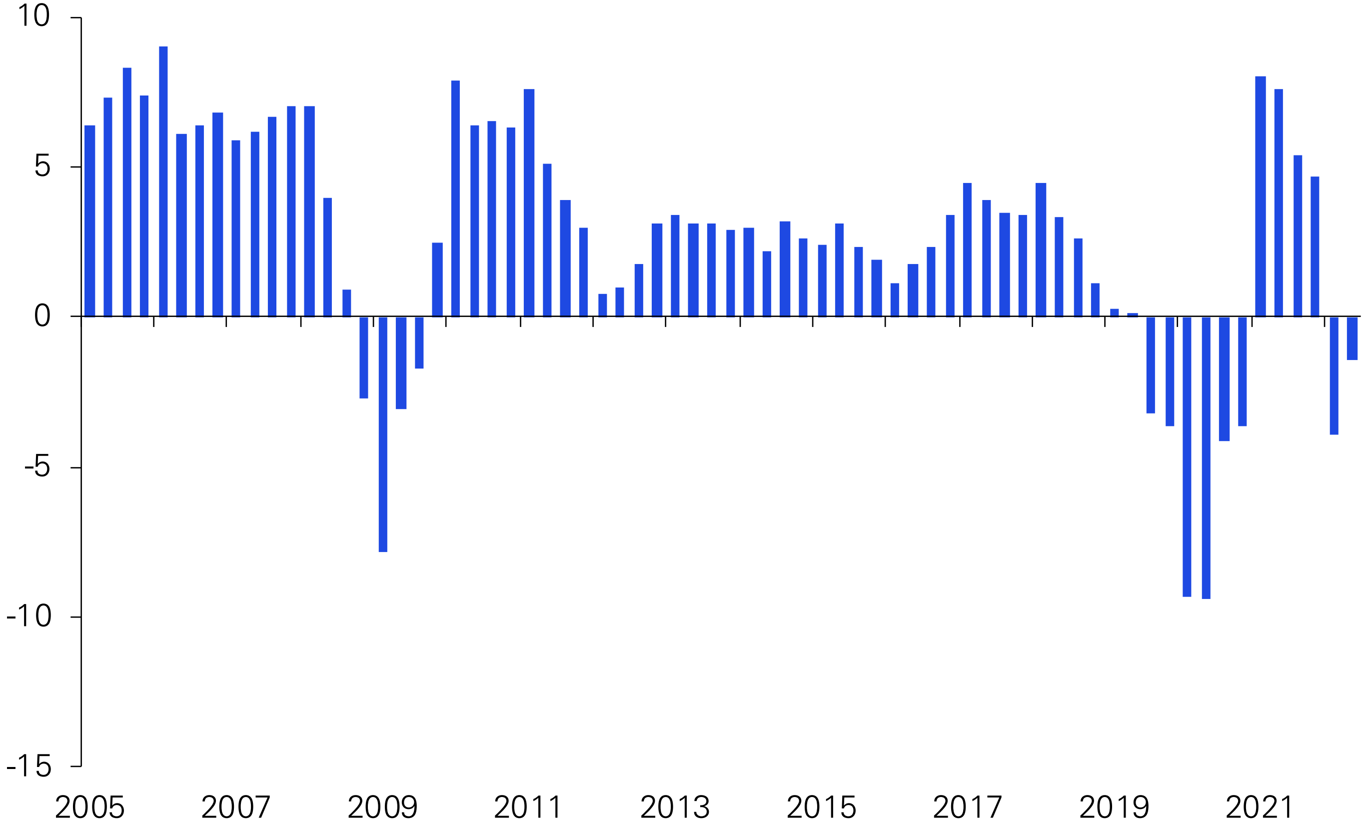


Source: Wind, KPMG analysis

- As the US Federal Reserve accelerating its monetary tightening by raising interest rates and reducing its balance sheet, the USD index has strengthened by 8.5% since late March. Combined with the impact of the Omicron outbreak, the RMB against the USD dropped by about 7% in March–May.
- With the recent outbreak under control and the economy starting to recover, the RMB's exchange rate against the basket of major currencies, as measured by CFETS, has rebounded since May.
- Looking forward, China's economic recovery and robust trade surplus should provide support to the RMB exchange rate.

Hong Kong's economic growth improved modestly in Q2, but challenges remain

Hong Kong's real GDP growth rate, yoy, %

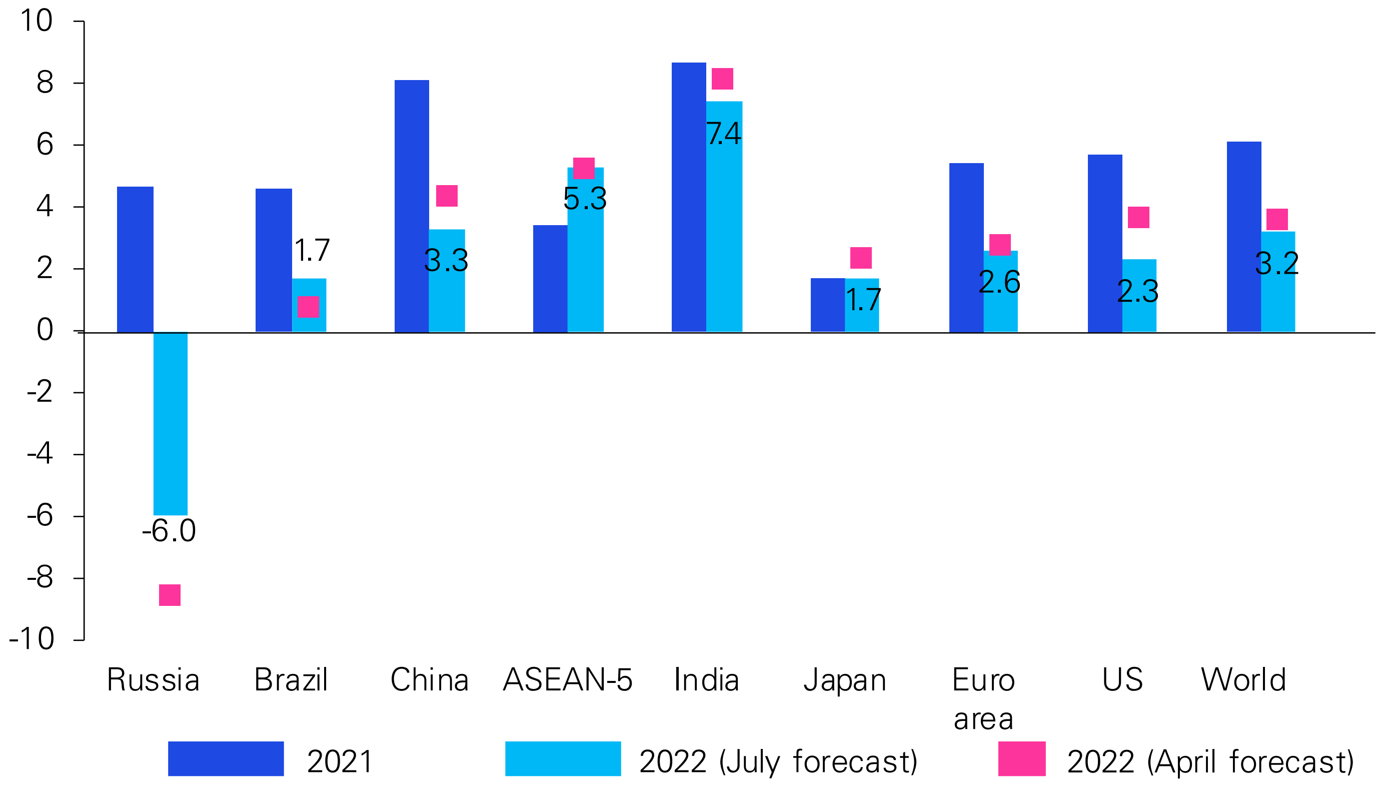


Source: Wind, KPMG analysis

- With COVID-19 cases stabilising and government's continued support measures, Hong Kong (SAR)'s economic growth improved in Q2. GDP growth was still down 1.4% in Q2 from a year ago, but the decline has narrowed from -3.9% in Q1.
- The decline of GDP was mainly attributable to weak performance in exports. Total goods exports declined 6.4% in June, after falling 1.4% in May. Retail sales also remained weak.
- Looking ahead, Hong Kong's economy will likely regain some momentum in H2, but strong headwinds including interest rate hikes and a global economic slowdown may continue to weigh on its recovery.

Global growth momentum weakens due to rising inflation, monetary tightening, and geopolitical uncertainty

Real GDP growth and forecast, %



- The IMF lowered its forecast on 2022 global economic growth to 3.2%, down 0.4 ppt from its April update, due to geopolitical tensions, commodity price fluctuations, and monetary tightening in many economies. It also revised up the global inflation forecast to 8.3% in 2022, up 1.4 ppt from the April update. In addition, it highlighted that the risks to the outlook are tilted to the downside.
- The downward revision was larger for advanced economies than for emerging markets. The US and major European economies are facing higher-than-expected inflation and steep monetary tightening. Growth of advanced economies was revised down by 0.8 ppt to 2.5% in 2022. Growth of emerging markets and developing economies was projected down by 0.2 ppt to 3.6%.

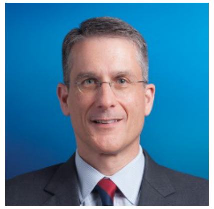
Source: IMF, KPMG analysis.
Note: ASEAN-5 includes Indonesia, Malaysia, Philippines, Thailand, Vietnam.

Contact us

Raymond Ng
Head of Markets
KPMG China
+86 (10) 85087067
raymond.kk.ng@kpmg.com

Norbert Meyring
Partner
KPMG China
+86 (21) 22122707
norbert.meyring@kpmg.com

Miguel Montoya
Partner
KPMG China
+86 (10) 85084470
miguel.montoya@kpmg.com



Thomas Stanley
COO of Markets
KPMG China
+86 (21) 22123884
thomas.stanley@kpmg.com

Kevin Kang
Chief Economist
KPMG China
+86 (10) 85087198
k.kang@kpmg.com

Research Team: Yuan Zeng, CFA; Yanan Zheng; Mingyan Ou (Intern)
Design: Zheng Zhu

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